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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1970

No. 467

IRVING GORDON and MARGARET GORDON, *Petitioners*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit

PETITIONERS' REPLY BRIEF

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The Government's brief in opposition to the petition reconfirms the position of petitioners that the decision of the court below presents an irreconcilable conflict with decisions of other circuits in *Estate of Stauffer v. C.I.R.* (9 Cir. 1968) 403 F.2d 611, *Associated Machine v. C.I.R.* (9 Cir. 1968) 403 F.2d 622, and *Carlberg v. United States* (8 Cir. 1960) 281 F.2d 507.

I. A CONFLICT OF DECISIONS IS INVOLVED BY THE GOVERNMENT'S OWN ADMISSION THAT THE SECOND CIRCUIT'S HOLDING ON THE TAX EFFECT OF A REORGANIZATION WHICH IS BOTH AN (F) AND (D)-TYPE IS NOT CONSISTENT WITH THE DECISIONS OF THE NINTH CIRCUIT IN THE STAUFFER AND ASSOCIATED MACHINE CASES.

The Government disputes petitioners' contentions that the rights to purchase Northwest stock were "stock or securities" of Pacific, and that the Pacific reorganization was an (F) reorganization (G.Br. 5). It should be noted that while the court below decided the Northwest rights were not "stock," it did not decide that the rights were not "securities"; it assumed that it was unnecessary to decide whether the rights were "securities". The court below also assumed that the Northwest reorganization was an (F) reorganization, but held that the receipt of the Northwest stock was not tax-free since the transaction was also a (D) reorganization, and was disqualified from tax-free treatment because of a provision in the tax law which applies only to (D) reorganizations.

The decision of the Second Circuit is contrary to the well-established principle that the reorganization provisions under section 368(a)(1)(A), (B), (D), (E), and (F) must be given separate, independent tax effect (Pet. 9-14). The Government has not attempted to refute this. Instead, it has asserted that the transaction here was not an (F) reorganization, relying on the Tax Court's decision.[1] Thus, the Government has neither addressed

[1]The Government does not elaborate on its reasons for this assertion. However, it purports to distinguish *Stauffer* and *Associated Machine* on the ground that they involved acquisitive reorganizations and not a divisive reorganization, as alleged by the Government to be present here. This distinction finds no support in the decision of the Tax Court (Appx. to Pet., pp. 23A-25A), nor in the statute or the cases cited by the Government.

itself to the important principle of tax law here presented, nor to the basis on which the Second Circuit rested its decision on the point.

If the Government intends to support the decision below on the ground that the transaction was not an (F) reorganization, that position is itself directly in conflict with the decisions in *Estate of Stauffer* and *Associated Machine* (see Pet. pp. 15-16).

If, on the other hand, the transaction is treated as an (F) reorganization, the Second Circuit's holding that its tax-free effect is precluded by restrictions on (D) reorganizations, is (as conceded in the Government's brief, page 9) also inconsistent with the Ninth Circuit's decisions in *Stauffer* and *Associated Machine*. In either event, the decision of the court below is irreconcilable with those Ninth Circuit decisions and warrants review by this Court.

II. THE LOWER COURT'S DEPARTURE FROM THE RULE IN THE PALMER CASE REQUIRES REVIEW BY THIS COURT.

One of the issues squarely presented to the court below was whether the Northwest rights were securities. The Second Circuit, however, refused to decide this issue, on the ground that even if the rights were securities, they were taxable when received. In its prior opinion in this case the Second Circuit had held that the exercise and not the receipt of the Northwest rights was the relevant tax event under *Palmer v. Commissioner* (1937) 302 U.S. 63.[2] When this case was earlier before this Court, the Government contended that the rule in *Palmer* as laid

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[2]To the same effect are all the prior decisions of the Tax Court and of the Ninth Circuit (see Pet. 17, n. 10).

down by the Second Circuit was not applicable under the 1954 Code. Under the disposition of the case by this Court on the prior decision, the Court found it unnecessary to decide this issue. But it stated in passing that application of the *Palmer* rule had not been authoritatively settled (Appx. to Pet. 63A). The Government now seeks to support the position of the court below that the rights would have been taxable as dividends upon receipt, contending that *Palmer* is neither applicable under the 1954 Code nor in conflict with the view of the court below that the rights here were taxable immediately. If the Second Circuit's decision is permitted to stand unchallenged without review by this Court, its holding will remain in irreconcilable conflict with prior decisions in that Circuit (including *Choate v. Commissioner of Internal Revenue* (2 Cir. 1942) 129 F.2d 684), and with the decisions of the Tax Court and of the Ninth Circuit in this and the companion cases. This Court's earlier recognition of the fact that it has not passed on the question of whether the rule in *Palmer* applies here in no way militates against the general understanding that it does apply.[3]

[3]One of the principal authorities cited by the Government for its position before the lower courts that the *Palmer* rule no longer applies under the 1954 Code was the article "Taxation of 'Taxable' Stock Rights: The Strange Persistence of *Palmer v. Commissioner*" by Carlson (23 Tax L.Rev. (1968) 129). The author there points out that the courts and the bar continue to give full effect to the *Palmer* rule.

III. THE SECOND CIRCUIT'S HOLDING THAT THE RIGHTS WERE NOT "STOCK" OF PACIFIC IS IN CONFLICT WITH THE CARLBERG DECISION OF THE EIGHTH CIRCUIT.

The Government erroneously attempts to reconcile the decision of the Second Circuit that the rights involved here were not "stock" with the decisions in *Carlberg v. United States* (8 Cir. 1960) 281 F.2d 507, and *James C. Hamrick* (1964) 43 T.C. 21.

The reason asserted by the Government for its contention that the Second Circuit decision is correct is that any definition of stock includes three privileges inherent in stock ownership (G.Br. 6)—(1) the right to vote in shareholders' meetings, (2) the right to participate in dividend distributions, and (3) the right to share in net assets on dissolution. The certificates of contingent interest considered by the Eight Circuit in the *Carlberg* case contained none of these privileges. Instead, they were present in the stock which the holders of the certificates held. Likewise, in the case at bar, these privileges were inherent in the ownership of the Pacific stock from which the Northwest rights were derived (see Pet. pp. 18, 20).

Nor does the presence of an option on the part of the Pacific shareholders in any way detract from considering the rights as stock. Such an option is no different from the option which any shareholder is given, under his pre-emptive rights, to make additional contributions of capital (*Miles v. Safe Deposit Co.* (1922) 259 U.S. 247).

IV. THE QUESTION PRESENTED UNDER SECTION 346(b) INVOLVES AN ISSUE OF CONTINUING IMPORTANCE IN THE ADMINISTRATION OF THE REVENUE LAWS.

The Government dismisses the section 346 issue as one involving no conflict and of no possible administrative importance because, although section 346 has been in the tax law since 1954, the case is one of first impression (G.Br. 11). The Government does not, as it cannot, deny that partial liquidations involving distributions of proceeds of terminated businesses are common business transactions which constantly occur. The decision of the court below involves a novel and heretofore unannounced limitation on the application of section 346. There is no indication as to what the policy of the Government has been on this aspect of the case in its ruling and administrative treatment. Previous rulings have shown the concern of taxpayers to determine the maximum amount that could be distributed on a capital gain basis under section 346. The court's novel application of this section now imposes a *minimum* limit on distributions from a terminated business. This new limitation requires examination by this Court of the propriety of creating a serious new restriction on frequently occurring business transactions.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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